DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 95-0401
Indiana Corporate Income Tax
For the Tax Years 1989, 1990, and 1991

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ISSUES

I. Applicability of the Adjusted Gross Income Tax and Gross Income Tax – Taxpayer's Income from Licensing Intellectual Property.

Authority: U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 8; IC 6-2.1-2-2; IC 6-3-1-1 et seq.; IC 6-3-2-2(a); 45 IAC 1-1-51; 45 IAC 3.1-1-55; Quill Corp. v. North Dakota, 504 U.S. 298 (1992); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); Int'l Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435 (1944); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994); Hoosier Energy v. Dept. of State Revenue, 572 N.E.2d 481 (Ind. 1991); Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993); Del. Code Ann. tit. 30 § 1902(b)(8).

Taxpayer protests the characterization of certain income received from the licensing of intangible patents, trademarks, and intellectual property.

II. Apportionment of Taxpayer's Income Derived from Licensing Intellectual Property.

Authorities: IC 6-3-2-2(a); 45 IAC 3.1-1-55.

Taxpayer argues that – in the event it is determined that it has an Indiana business situs – that the income derived from the licensing of intellectual property should be apportioned to those states in which the ultimate sale of the licensed goods are sold.

III. Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the Department of Revenue (Department) exercise its discretion to abate the ten-percent negligence penalty made against taxpayer's additional corporate income tax assessment.

STATEMENT OF FACTS

Taxpayer is a wholly owned subsidiary of Indiana parent company. Parent company is an Indiana based manufacturer of transmission parts. As a manufacturer, the parent company owns valuable patents, trademarks, and certain other intellectual property (hereinafter "intellectual property"). The taxpayer was first incorporated in Delaware after parent company was purchased by a New York holding company.

Taxpayer has, as its physical location, an office in Delaware. Taxpayer has no physical presence in Indiana. It has no office, no employees, and no tangible personal property in Indiana.

Shortly after taxpayer was incorporated in Delaware, taxpayer and Indiana parent company entered into an agreement whereby Indiana parent company assigned all of its intellectual property to the taxpayer. Taxpayer states that the agreement was entered into at the direction of New York holding company. According to taxpayer, this decision was made "to insulate and protect [the intellectual property] from the day-to-day operational and financial risks of [Indiana parent company's] business as a manufacturer." In exchange for the assignment of the intellectual property, Indiana parent company received all of taxpayer's issued and outstanding common stock. Simultaneously with that stock transfer, taxpayer and Indiana parent company received the exclusive right to make use of the intellectual property.

As consideration for the right to use the intellectual property, Indiana parent company paid taxpayer an initial fee of $500,000 and agreed to pay additional yearly fees consisting of five percent of the annual gross sales of certain products manufactured and sold by Indiana parent company. On the same date that taxpayer received the $500,000 initial fee from Indiana parent company, taxpayer paid a $500,000 dividend to Indiana parent company. Thereafter, taxpayer engaged in the regular practice of loaning to Indiana parent company the same amounts as Indiana parent company paid in royalties to taxpayer. Consequently, Indiana parent company received a deduction for the payments made to taxpayer. This deduction had the effect of reducing Indiana parent company's taxable Indiana gross income. In contrast, taxpayer has never filed Indiana income tax returns. Delaware does not tax income derived from "patents, patent applications, trademarks, trade names and similar types of intangible assets . . . ." Del. Code Ann. tit. 30 § 1902(b)(8).

The audit has proposed adjusted gross income taxes on the amounts taxpayer received from Indiana parent company for 1989, 1990, and 1991. The audit came to this conclusion believing that the facts indicated taxpayer was established by the Indiana parent company as a vehicle to shield a percentage of Indiana parent company's income from state income taxes. In support of this conclusion, the audit cites to the following:

> The Indiana parent company owns 100 percent of taxpayer.
>
> Taxpayer's income producing assets consist solely of Indiana parent company's intellectual property.
>
> Taxpayer licenses the intellectual property exclusively to Indiana parent company.
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> Taxpayer, Indiana parent company, and New York holding company share common officers and directors.

> All of taxpayer's income derived from Indiana parent company's royalties, bank interest on the royalty income, and Indiana parent company's loan interest payments. There was no evidence that the loan was ever repaid.
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> The royalty payments – made by Indiana parent company to taxpayer – were returned to Indiana parent company by the terms of the parties' loan agreement.
>
> The Indiana parent company – even subsequent to the purported assignment of the intellectual property to taxpayer – continued to exercise ownership control over the intellectual property. These ownership rights are evidenced by the Indiana parent company's practice, on multiple occasions, of using the intellectual property as security in order to obtain additional financing from unrelated third parties. Audit determined that Indiana parent company, on at least four occasions, assigned rights to the intellectual property to three different financing entities. In each case the security interest was assigned after the Indiana parent company had purportedly made a definitive assignment of the same intellectual property rights to taxpayer.

In summary, the audit concluded that the Indiana parent company continues to own and control the intellectual property, Indiana is the business situs of the intellectual property, and that the income derived from the use of the intellectual property is Indiana source income and properly taxable to the state of Indiana. Additionally, the audit argued that Indiana is entitled to ignore taxpayer's separate corporate existence and to treat, for purposes of determining the parties' corporate income tax liability, taxpayer and its Indiana parent company as a single entity.

DISCUSSION

I. Applicability of the Adjusted Gross Income Tax and Gross Income Tax.

A. Adjusted Gross Income Tax.

Indiana imposes an adjusted gross income tax on income derived from sources within the state. The adjusted gross income tax, IC 6-3-1-1 et seq., is an apportioned tax specifically designed to reach income derived from interstate transactions. Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264, 266 n. 4 (Ind. 1994). The legislature has defined "adjusted gross income" as follows:

> (1) income from real or tangible property located in this state; (2) income from doing business in this state; (3) income from a trade or profession conducted in this state; (4) compensation for labor or services rendered within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. IC 6-3-2-2(a).

IC 6-3-2-2 was amended January 1, 1990, midway through taxpayer's audit cycle. However, the amendment only affected the attribution of interest and dividend income and did not touch upon or affect other income sources – including income attributable to intellectual property –

previously and currently listed within IC 6-3-2-2(a)(5). Because the legislature made no change in the language regarding the tax treatment of income attributable to intellectual property when it amended IC 6-3-2-2(a)(5), there is no reason to presume that Department regulation 45 IAC 3.1-1-55, and its reference to the business situs of intangible personal property, does not continue to apply with full force.

In order for Indiana to tax the income derived from an intangible, the intangible – such as taxpayer's intellectual property – must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 states that "[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a "business situs" elsewhere. 'Business situs is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property."

It is apparent that the taxpayer's intellectual property has acquired a "business situs" within Indiana. Taxpayer licenses the intellectual property for the exclusive use by the Indiana parent company which conducts its manufacturing activity within the state. The value taxpayer derives from the exploitation of the intellectual property is attributable entirely to activities occurring within the state of Indiana. The value of the intellectual property to the taxpayer consists solely of the ability to "place" that intellectual property within the state and to derive the consequent economic benefits attributable entirely to the intellectual property's Indiana business situs. As the regulation itself states, "'Business situs' is the place at which [the] intangible personal property is employed as capital . . . ." 45 IAC 3.1-1-55. The place at which "value attaches to the [intellectual] property" is within the state of Indiana. Id.

In addition, the fact that taxpayer's intellectual property has acquired a business situs within the state is evidenced by Indiana parent's company's independent exploitation of that same intellectual property. In transactions entirely unrelated to the taxpayer's licensing of the intellectual property for use within the state, Indiana parent company has, on multiple occasions, assigned the intellectual property as security interest to unrelated third parties. Again, the regulation states that the business situs of intangible property is that place where "the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property." Id. Indiana parent's exercise of ownership rights over the intellectual property indicates that "possession and control of the property is localized" within the state.

It cannot be denied that the value of the intellectual property to the taxpayer derives entirely from the ability to assign the intellectual property to Indiana parent company and for taxpayer to reap the benefits derived from exploiting the intellectual property through activities occurring entirely within the state. It would be a meaningless and unprofitable exercise in formalistic property rights for taxpayer to husband the intellectual property entirely within Delaware.

However, taxpayer interposes several constitutional arguments which would have the effect of limiting Indiana's ability to tax the income attributable to the intellectual property. Taxpayer states that "[t]he imposition of taxation on [taxpayer] as a foreign corporation violates the Commerce Clause and the Due Process Clause of the U.S. Constitution." Taxpayer is correct in its assertion that both the Due Process Clause, U.S. Const. amend. XIV, § 8, and the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, require that there exist a minimum connection between a state and the object of the tax and that those constitutional requirements must be met before Indiana can exercise taxing authority over taxpayer's income.

In Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992), the Supreme Court stated that "[t]he Due Process Clause 'requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax.'" However, the Court concluded that the due process requirement is satisfied "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum state . . . . even if the [the taxpayer] has no physical presence in the state." Id. at 307. Although taxpayer's physical existence – measured by its business location, employees, and corporate existence – may be confined within Delaware's boundaries, taxpayer has directed its activities at the residents of Indiana and at the benefits conferred by Indiana in making it possible for taxpayer to conduct business within the state. Taxpayer has not been unwillingly brought into contact with Indiana by the unforeseen and unilateral actions of an independent third-party. To the contrary, there is every indication that taxpayer directed its activities toward licensing the intellectual property to Indiana parent company and received substantial income from the use of the intellectual property within the state. The fact that Indiana confers protection, benefits, and opportunities upon taxpayer is apparent from taxpayer's simple ability to derive income from conducting business within the state. Therefore, under the standards set out in the Quill decision, the Due Process Clause does not prevent Indiana from taxing the income derived by taxpayer in availing itself of the Indiana business situs.

Taxpayer argues that Indiana may not tax its income by virtue of the protections afforded under the Commerce Clause. In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), the Supreme Court outlined a four-part test for determining whether a state's exercise of its taxing authority is offensive to the Commerce Clause. The Court stated the exercise of the state's taxing authority would survive a constitutional challenge "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." Id. Taxpayer argues that the proposed tax violates the Commerce Clause because taxpayer does not have a "substantial nexus" with Indiana and because the tax is not "fairly apportioned."

Taxpayer claims that it does not have a "substantial nexus" with Indiana because it is not commercially domiciled in Indiana, does not have a business situs in Indiana, conducts no business in Indiana, derives no services from Indiana, and has no employees or property within the state. However, as the court in Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13, 23 (S.C. 1993), *cert. denied,* 510 U.S. 992 (1993), noted, "It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property is sufficient alone to establish nexus." That determination echoed the standard set out by the Supreme Court in Int'l Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435, 441-442 (1944) when the Court stated that, "A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers." (*See also* Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936) "The rule that the taxable situs of intangibles is at the technical domicile of the owner is but a mere fiction, and will not be followed when the fact is clear that the intangible property has a situs elsewhere.") The contractual relationship between taxpayer and Indiana parent company creates the requisite "substantial nexus" with Indiana necessary for Indiana to subject taxpayer to its adjusted gross income tax. By virtue of that licensing agreement, Indiana parent company uses the intellectual property to enhance the value of the products manufactured within the state and to generate the sales which form the basis upon which the taxpayer receives a continuous stream of royalty income.

In addition, the taxpayer argues that the proposed tax violates the Commerce Clause because the tax is not "fairly apportioned." Taxpayer apparently argues that the income at issue should "apportioned" back to the state of Delaware. As the court in Hoosier Energy v. Dept. of State Revenue, 572 N.E.2d 481, 485 (Ind. 1991) stated, "As a general proposition, a state tax on interstate commerce must be fairly apportioned to prevent excessive taxes on such sale as each state takes its bite out of the interstate transaction as it passes through each taxing state." Therefore, in order for a tax to meet the Complete Auto "fairly apportioned" requirement, the state must demonstrate that the taxpayer's income is not consumed by multiple states exercising successive taxing authority over the same income in a manner which offends the Commerce Clause. However, taxpayer has presented no evidence indicating that the income is in anyway potentially subject to multiple taxation. The only other state which could conceivably exercise taxing authority over the income is Delaware which is where taxpayer is physically located. There is simply no indication that Delaware has or will subject the income to its taxing authority. To the contrary, Del. Code Ann. tit. 30 § 1902(b)(8) would seem to specifically exempt income derived from intellectual property from the state's taxing authority. The statute states, in relevant part that:

> The following corporations shall be exempt from taxation under this chapter: (8) Corporations whose activities within this State are confined to the maintenance and management of their intangible investments . . . and the collection and distribution of the income from such investments . . . . For purposes of this paragraph, "intangible investments" shall include, without limitation, investments in . . . patents, patent applications, trademarks, trade names and similar types of intangible assets . . . .

In the absence of any indication whatsoever that taxpayer's income would be subject to successive taxation by multiple states, taxpayer's "fairly apportioned" argument must fail. To the contrary, the evidence supports the conclusion that the imposition of the state's adjusted gross income tax meets the apportionment requirements set forth in Complete Auto.

Accordingly, because taxpayer's intellectual property has acquired an Indiana "business situs," and because Indiana's exercise of taxing authority over the income derived from that property does not offend either the Due Process Clause or the Commerce Clause, taxpayer's income is properly subject to the state's adjusted gross income tax scheme.

B. Gross Income Tax.

In addition to the adjusted gross income tax, Indiana imposes a tax, known as the "gross income tax," on the "taxable gross income" of a taxpayer who is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2.

Under the regulations governing the gross income tax, "taxable gross income" includes income that is derived from "intangibles." 45 IAC 1-1-51. The term "intangibles" includes:

> notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps," final judgments, leases, royalties, certificates of sale, choses in action *and any and all other evidences of similar rights capable of being transferred, acquired or sold.* (*Emphasis added*). Id.

In order for Indiana to impose the gross income tax on income derived from taxpayer's intangibles, the Department must determine that the income is derived from a "business situs" within the state. Id. The regulation states that taxpayer has established a "business situs" within the state "[i]f the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana . . . ." Id. Once the taxpayer has established a "business situs" within the state, "and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes." Id.

It is apparent that the income derived from the taxpayer's licensing of the intellectual property, is income derived from a "business situs" within Indiana and is properly subject to the state's gross income tax scheme. The intellectual property is exclusively licensed to Indiana parent company. The intellectual property is "localized" within the state in the sense that the Indiana parent company employs the property to enhance the value of goods manufactured within the state. Taxpayer would derive no income from the intellectual property except for the fact that the intellectual property was licensed for use within Indiana and then actually used within Indiana in conjunction with manufacturing activities themselves occurring within the state.

Accordingly, because the intangible intellectual property has acquired a business situs within the state and because the income at issue is "connected with that business, either actually or constructively," the income is subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Apportionment of Taxpayer's Income Derived from Licensing Intellectual Property.

Taxpayer has submitted an additional argument relevant in the event that the Department determines that taxpayer has a taxable presence within the state.

Taxpayer entered into an agreement to license certain intellectual property back to parent company. Parent company paid taxpayer for the privilege of using that intellectual property. Parent company used the intellectual property in the construction of its engines. Parent company sold its engines to customers located in Indiana and other states.

Taxpayer argues that the source of its income was derived from the sale of parent company's engines to the ultimate consumers of those engines. Because parent company sold most of its engines to out-of-state customers, the income producing "events" occurred in those out-of-state locations and – as a result – the income attributable to the out-of-state "events" may not be apportioned to Indiana. Specifically, because only .4 percent (four-tenths of one percent) of parent company's sales were made in Indiana, only .4 percent of taxpayer's licensing and royalty income could be apportioned to Indiana. As a consequence, 99.6 percent of taxpayer's income would be apportioned to out-of-state sources.

Indiana imposes the adjusted gross income tax on income derived from sources within this state. The legislature has defined "adjusted gross income" as "(1) income from real and tangible or tangible personal property located in this state; (2) income from doing business in this state; (3) income from a trade or profession within this state; (4) compensation for labor or services within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter . . . ." IC 6-3-2-2(a).

The regulations provide that Indiana may not tax the income derived from intangible property unless the intangible property has acquired a situs within the state. Specifically, the regulation states:

> The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a "business situs" elsewhere. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the [intangible] property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property. 45 IAC 3.1-1-55.

Therefore, Indiana may not apportion to itself income from intangible personal property unless the taxpayer has a commercial domicile within the state or the intangible property has acquired a "business situs" within the state. Clearly, taxpayer's commercial domicile is Delaware because Delaware is the location from which taxpayer directs and manages its trade or business. Therefore the issue becomes whether the intangible personal property – taxpayer's intellectual property – has acquired a "business situs" within Indiana.

Taxpayer maintains that the "business situs" of the intellectual property is the location of the ultimate sale of each of parent company's engines. Under the scenario proposed by taxpayer, if parent company sold 1,000 engines, taxpayer's intellectual property would have acquired a "business situs" in 1,000 different locations.

Taxpayer misapprehends the application of the apportionment regulation. Taxpayer has entered into a mutually beneficial agreement with parent company which enables parent company to employ taxpayer's intellectual property to construct its engines. The fact that the completed engines are then shipped to multiple in-state and out-of-state locations, and then sold to at those multiple locations, is an irrelevancy when determining the "business situs" of the intellectual property. Because Indiana is the location of the "trade or business [where] substantial value attaches to the [intellectual] property" (45 IAC 3.1-1-55), Indiana is the "business situs" of that intellectual property. Clearly, Indiana parent company is the place where "possession and control of the property is localized." Id. If one of Indiana parent company's numerous out-of-state engine customers reverse engineered that engine, used the patented techniques to produce its own line of competing engines, and attached parent company's trade mark to that line of engines, parent company would be entitled to protest the out-of-state customer's transgression of its intellectual property. The out-of-state trespasser – making the initial purchase of parent company's engine – did not acquire any rights to the intellectual property because the "possession and control of the property is localized" with Indiana parent company. The mere fact that taxpayer's income is, in part, *measured* by the number of engines parent company sells to both in-state and out-of-state customers, does not change the fact that taxpayer's licensing agreement was *with* Indiana parent company and that possession and control of the intellectual property was invested exclusively with Indiana parent company.

Conversely, taxpayer's argument would possibly have a certain cogency had taxpayer entered into multiple agreements – for the same intellectual property – with different licensees of that property. If taxpayer had licensed the property to an Indiana, Wisconsin, and Connecticut licensor, Indiana would be entitled to apportion to itself only that income derived from the agreement entered with the Indiana licensee.

Taxpayer cites to the Department's own administrative rulings in support of its argument. In the cited Letter of Findings, the Department found that the income an out-of-state franchisor received from agreements with Indiana franchisees was – for purposes of the state's adjusted gross income tax scheme – Indiana source income. As that earlier Letter of Findings determined, "what the taxpayer sells and the franchisee purchases, is the right to vigorously exploit the intangible asset." However, in the same way that the out-of-state franchisor received Indiana source income from entering into franchise agreements with the individual franchisees, taxpayer has received Indiana source income after it entered into an agreement with Indiana parent company. That the Indiana franchisees may have occasionally sold their food products – labeled with out-of-state franchisor's brand name – to out-of-state customers, was irrelevant. That the taxpayer's parent company sold the majority of its engines – labeled with taxpayer's licensed trade name and built with taxpayer's patents – to out-of-state customers is equally irrelevant.

Taxpayer entered into a licensing agreement with Indiana parent company. The agreement placed the licensed intellectual property within the control and possession of Indiana parent company. Substantial value attached to the intellectual property when the property was "localized" with Indiana parent company. The income paid as consideration for the right to possess, control, and exploit that that property derived from placing that property at an Indiana business situs and is entirely attributable to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

III. Ten-Percent Negligence Penalty.

Taxpayer has requested that the Department exercise its statutory discretion to abate the ten-percent negligence penalty assessed under authority of IC 6-8.1-10-2.1(a). The penalty was assessed against the taxpayer's additional corporate income tax liabilities determined for the years 1989, 1990, and 1991.

IC 6-8.1-10-2.1(d) provides potential relief from imposition of the penalty. The statute states that if a person – subject to the negligence penalty imposed under IC 6-8.1-10-2.1(a) – can demonstrate that the failure to file a tax return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay a deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations."

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish "reasonable cause" by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." Id. In determining whether "reasonable cause" exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

The Department finds that the taxpayer has established "reasonable cause" sufficient to warrant abating the ten-percent negligence penalty.

FINDING

Taxpayer's protest is sustained.

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